



**PRELIMINARY DECISION**  
**Powercor distribution**  
**determination**  
**2016 to 2020**

**Attachment 15 – Pass through**  
**events**

October 2015

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## Note

This attachment forms part of the AER's preliminary decision on Powercor's revenue proposal 2016–20. It should be read with all other parts of the preliminary decision.

The preliminary decision includes the following documents:

Overview

Attachment 1 - Annual revenue requirement

Attachment 2 - Regulatory asset base

Attachment 3 - Rate of return

Attachment 4 - Value of imputation credits

Attachment 5 - Regulatory depreciation

Attachment 6 - Capital expenditure

Attachment 7 - Operating expenditure

Attachment 8 - Corporate income tax

Attachment 9 - Efficiency benefit sharing scheme

Attachment 10 - Capital expenditure sharing scheme

Attachment 11 - Service target performance incentive scheme

Attachment 12 - Demand management incentive scheme

Attachment 13 - Classification of services

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Attachment 15 - Pass through events

Attachment 16 - Alternative control services

Attachment 17 - Negotiated services framework and criteria

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## Shortened forms

Shortened form	Extended form
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
AMI	Advanced metering infrastructure
augex	augmentation expenditure
capex	capital expenditure
CCP	Consumer Challenge Panel
CESS	capital expenditure sharing scheme
CPI	consumer price index
DRP	debt risk premium
DMIA	demand management innovation allowance
DMIS	demand management incentive scheme
distributor	distribution network service provider
DUoS	distribution use of system
EBSS	efficiency benefit sharing scheme
ERP	equity risk premium
Expenditure Assessment Guideline	Expenditure Forecast Assessment Guideline for electricity distribution
F&A	framework and approach
MRP	market risk premium
NEL	national electricity law
NEM	national electricity market
NEO	national electricity objective
NER	national electricity rules
NSP	network service provider
opex	operating expenditure
PPI	partial performance indicators
PTRM	post-tax revenue model
RAB	regulatory asset base
RBA	Reserve Bank of Australia
repex	replacement expenditure

Shortened form	Extended form
RFM	roll forward model
RIN	regulatory information notice
RPP	revenue and pricing principles
SAIDI	system average interruption duration index
SAIFI	system average interruption frequency index
SLCAPM	Sharpe-Lintner capital asset pricing model
STPIS	service target performance incentive scheme
WACC	weighted average cost of capital

## 15 Pass through events

The pass through mechanism of the NER recognises a distributor can be exposed to risks beyond its control, which may have a material impact on its costs. A cost pass through enables a distributor to recover (or pass through) the costs of defined unpredictable, high cost events not built into our distribution determination. The NER includes the following prescribed pass through events:

- a regulatory change event
- a service standard event
- a tax change event
- a retailer insolvency event.<sup>1</sup>

In addition to the above (prescribed) events, an event may be specified in a determination for a regulatory control period (nominated pass through event).<sup>2</sup>

Powercor proposed seven nominated pass through events in addition to the events prescribed by the NER.<sup>3</sup>

This attachment sets out our preliminary decision on the additional pass through events for Powercor during the 2016–20 regulatory control period.

### 15.1 Preliminary decision

We do not accept the following nominated pass through events as put to us by Powercor, but our draft decision includes alternative definitions for these events:

- insurance event
- insurer credit risk event
- natural disaster event
- terrorism event
- retailer failure event.

We do not accept the following proposed events:

- end of metering derogation event
- multiple trading relationships event.

The pass through events approved in this decision will apply to direct control services.

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<sup>1</sup> Note, this is only a prescribed event in jurisdictions where the National Energy Customer Framework has commenced, and therefore does not apply in Victoria.

<sup>2</sup> NER, cl. 6.6.1(a1).

<sup>3</sup> Powercor, *Regulatory Proposal 2016-2020*, April 2015, p. 266.

## 15.2 Powercor's proposal

Powercor's nominated pass through events are set out in Table 15-1 . Powercor also proposed that:

- the pass through mechanism apply to direct control services
- a new definition of pass through event materiality be established for alternative control services
- the control mechanism for alternative control service be varied so pass through costs may be recovered from alternative control service customers.

**Table 15-1 Powercor's proposed pass through events**

Proposed event	Powercor's proposed definition
Insurance event	<p>"An "insurance event" occurs if:</p> <p>a) the distributor makes a claim on a relevant insurance policy; and</p> <p>b) the distributor incurs costs beyond the relevant policy limit.</p> <p>For the purposes of this insurance event:</p> <p>a) the relevant policy limit is the distributor's actual policy limit at the time of the event that gives rise to the claim; and</p> <p>b) a relevant insurance policy is an insurance policy held during the 2016-2020 regulatory control period or a previous regulatory control period in which Powercor was regulated."</p>
Insurer's credit risk event	<p>"An insurance credit risk event occurs if, as a result of the insolvency of an insurer, the distributor:</p> <p>(1) incurs higher or lower costs for insurance premiums;</p> <p>(2) in respect of a claim for a risk that would have been insured by the distributor's insurers, is subject to a higher or lower claim limit or a higher or lower deductible than would have otherwise applied under the relevant policy; and/or</p> <p>(3) incurs additional costs associated with self-funding an insurance claim, which would have otherwise been covered by the insolvent insurer."</p>
Natural disaster event	<p>"A natural disaster event occurs if:</p> <p>Any major fire, storm, flood, earthquake or other natural disaster beyond the reasonable control of the DNSP that occurs during the 2016-20 regulatory control period.</p> <p>The term 'major' in the above paragraph means an</p>



Proposed event	Powercor's proposed definition
	<p>event that is serious and significant. It does not mean 'materially' as that term is defined in the Rules (that is 1 per cent of the distributor's annual revenue requirement for that regulatory year)."</p>
Terrorism event	<p>"An act (including, but not limited to, the use of force or violence, the threat of force or violence, attacks or other disruptive activities against, or the deliberate introduction of harmful code or viruses to, computer systems, computer networks, data and/or communication systems, or the threat of such attacks or disruptive activities, or of the deliberate introduction of such harmful code or viruses) of any person or group of persons (whether acting alone or on behalf of or in connection with any organisation or government), which from its nature or context is done for, or in connection with, political, religious, ideological, ethnic or similar purposes or reasons (including the intention to influence or intimidate any government and/or put the public, or any section of the public, in fear)."</p>
End of metering derogation event	<p>"An ending of the metering derogation event occurs if the impending or actual expiry of the Victorian Metering Derogation:</p> <p>(1) results in the distributor incurring costs to facilitate the introduction of metering contestability(whether prior to, or subsequent to the expiry of that Derogation) including, but not limited to:</p> <ul style="list-style-type: none"> <li>(a) system costs for establishing metering contestability;</li> <li>(b) meter provider of last resort costs; and</li> <li>(c) costs incurred to obtain non-metrology data from meters to enable the distributor to operate its network; and</li> </ul> <p>(2) does not constitute any category of pass through event specified in clause 6.6.1(a1)(1) to (4) of the Rules.</p> <p>For the purposes of this metering derogation event, the Victorian Metering Derogation is the derogation currently provided for in clause 9.9C of the Rules pursuant to the AEMC, National Electricity Amendment (Victorian Jurisdictional Derogation – Advanced Metering infrastructure) Rule 2013, 28 November 2013 and any subsequent derogation which may be made with similar effect to that in clause 9.9C of the Rules, albeit with a different expiry date."</p>
Multiple trading relationships event	<p>"A multiple trading relationships event occurs if a change (including without limitation any NEM procedure or system change) occurs that:</p> <p>(1) facilitates two or more entities being able to provide</p>

Proposed event	Powercor's proposed definition
Retailer failure event	<p>services at a single connection point; and</p> <p>(2) does not constitute any category of pass through event specified in clause 6.6.1(a1)(1) to (4) of the Rules.”</p> <p>“A retailer failure event occurs if a distributor incurs costs as a result of the failure of a retailer during a regulatory control period to pay a distributor an amount to which the distributor is entitled for the provision of direct control services, if:</p> <p>(a) an insolvency official has been appointed in respect of that retailer; and</p> <p>(b) the distributor is not entitled to payment of that amount in full under the terms of any credit support provided in respect of that retailer.</p> <p>For the purposes of this definition:</p> <p>(a) The term 'costs' includes amounts which the distributor was entitled to be paid (but which are or will be unpaid as a result of a retailer failure event) for the provision of direct control services, including, but not limited to:</p> <p>(i) charges for direct control services provided by the distributor;</p> <p>(ii) charges to recover the designated pricing proposal charges incurred by that distributor, and</p> <p>these amounts must be taken to be a cost that can be passed through and not a revenue impact of the event.</p> <p>(b) The term 'insolvency official' means a receiver, receiver and manager, administrator, provisional liquidator, liquidator, trustee in bankruptcy or person having a similar or analogous function.</p> <p>(c) The term 'credit support' takes its ordinary and natural meaning.</p> <p>(d) Other terms used in this definition that are defined in the Rules take their definition in the Rules.”</p>

Source: Powercor, *Regulatory Proposal 2016-2020*, April 2015, pp. 265-271.

### 15.3 AER's assessment approach

We must decide which of Powercor's proposed nominated pass through events will apply for the 2016–20 regulatory control period. Pass through events transfer financial risks from distributors to consumers. If one of the nominated events occurs, the costs

of the event that we assess as meeting the factors set out in the NER are passed through to consumers and network charges increase.<sup>4</sup>

Our approach has been guided by the National Electricity Objective (NEO) and the Revenue and Pricing Principles. These provide the distributor with a reasonable opportunity to recover at least the efficient costs incurred in providing services.<sup>5</sup> They also provide incentives to promote economic efficiency.<sup>6</sup> Together, they promote a balance between the economic costs and risk management to promote efficient investment.<sup>7</sup>

The NER include the following nominated pass through event considerations which we must have regard to when assessing nominated pass through events.<sup>8</sup>

The *nominated pass through event considerations* are:

(a) whether the event proposed is an event covered by a category of *pass through event* specified in clause 6.6.1(a1)(1) to (4) (in the case of a distribution determination) or clause 6A.7.3(a1)(1) to (4) (in the case of a transmission determination);

(b) whether the nature or type of event can be clearly identified at the time the determination is made for the service provider;

(c) whether a prudent service provider could reasonably prevent an event of that nature or type from occurring or substantially mitigate the cost impact of such an event;

(d) whether the relevant service provider could insure against the event, having regard to:

(1) the availability (including the extent of availability in terms of liability limits) of insurance against the event on reasonable commercial terms; or

(2) whether the event can be self-insured on the basis that:

(i) it is possible to calculate the self-insurance premium; and

(ii) the potential cost to the relevant service provider would not have a significant impact on the service provider's ability to provide *network services*; and.

(e) any other matter the *AER* considers relevant and which the *AER* has notified *Network Service Providers* is a nominated pass through event consideration.<sup>9</sup>

These considerations involve an assessment of the incentives for distributors to manage their risks efficiently.

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<sup>4</sup> NER, cl. 6.6.1(d),(g) and (j).

<sup>5</sup> NEL, s. 7A(2).

<sup>6</sup> NEL, s. 7A(3).

<sup>7</sup> NEL, s. 7A(6).

<sup>8</sup> NER, cl. 6.5.10(b); NER glossary, definition of 'nominated pass through event considerations'.

<sup>9</sup> NER, cl. 6.5.10(b); NER glossary, definition of 'nominated pass through event considerations'.

For systemic risks, distributors are compensated through the allowed rate of return. Distributors also face business-specific, or residual, risks. These activities are generally compensated through the opex and capex allowances. Beyond this, a distributor may manage other risks through a number of other strategies, including:

- prevention (avoiding the risk)
- mitigation (reducing the negative effect or probability of the risk)
- insurance (transferring the risk to another party)
- self-insurance (putting aside funds to manage the likely costs associated with a risk event).

An efficient business will manage its risk by employing the most cost effective combination of these strategies. For example, if a cost is reasonably predictable a business should factor it into its proposed opex and capex. In addition, a distributor may invest in its networks to mitigate the impact of certain events occurring. Alternatively, if the probability of events occurring can be readily estimated then the event should be insurable.

Pass through events cover those limited circumstances for which the risks cannot be managed efficiently in these ways and for which the distributor should be able to recover its efficient costs.

A factor for us to consider, which is reflected in the pass through event considerations, is who is best placed to manage a given risk. Generally, the party in the best position to manage a risk should bear the risk of that event occurring. If the distributor, or customers, are fully exposed to a risk, this may lead to adverse outcomes.

For example, where it is not possible for a distributor to insure against a risk, a distributor may need to share that risk with customers to ensure the service may continue should the event occur. The uninsurable risk may also be outside the control of the distributor and have a low probability of occurring, but a significant cost impact when it does occur. The most efficient and prudent solution to manage that type of risk may be to require customers to accept some of the burden of that risk, by allowing a pass through in the unlikely event that the risk eventuates.

On the other hand, if the distributor is able to pass through all the costs of such an event, its incentive to take prudent actions to prevent or mitigate the potential cost impact of the risk may be weakened. Accordingly, while customers may need to accept some of the burden of the risk, the distributor will need to share some of the risk too. That might be achieved, for example, by making a pass through conditional on the distributor demonstrating it has acted prudently and efficiently in managing the potential impact of the event.

We consider all of these issues when assessing a nominated pass through event with the aim of achieving the right balance, in the long term interests of consumers, in accordance with the nominated pass through event considerations.

As a matter of good regulatory practice, an additional factor we take into account is consistency in our approach to assessing nominated pass through events across our determinations.

### **15.3.1 Interrelationships**

As we mentioned above, pass through events are not the only mechanism in this determination by which Powercor can manage its risks. The nominated pass through events are interrelated with other parts of this determination, in particular with the proposed opex and capex allowances and the rate of return. These interrelationships require us to balance the incentives in the various parts of our decision.

## **15.4 Reasons for preliminary decision**

In this section we set out the reasons for our preliminary decision on each of Powercor's proposed pass through events. We have:

- not accepted the insurance event, insurer credit risk event, natural disaster event, terrorism event and retailer failure event, and proposed alternative definitions for these events
- not accepted the end of metering derogation event or multiple trading relationships event
- accepted the application of nominated pass through events to alternative control services, but not approved a new materiality definition for pass through events and not approved a variation to the control mechanism for alternative control services.

### **15.4.1 Pass throughs and alternative control services**

We approve Powercor's proposal that nominated pass through events refer to 'direct control services'. This means Powercor may apply to pass through an increase (or decrease) in costs incurred in providing both standard and alternative control services. This is consistent with the prescribed pass through event definitions set out in the NER, which also reference direct control services.

However, for the reasons outlined below, we do not accept Powercor's proposed variation to the way in which the pass through mechanism applies to alternative control services.

Powercor proposed to establish a new materiality definition applicable to alternative control services. The NER currently provides:<sup>10</sup>

For the purposes of the application of clause 6.6.1, an event results in a Distribution Network Service Provider incurring materially higher or materially lower costs if the change in costs (as opposed to the revenue impact) that the

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<sup>10</sup> NER, glossary, definition of 'materially'.

Distribution Network Service Provider has incurred and is likely to incur in any regulatory year of a regulatory control period, as a result of that event, exceeds 1% of the annual revenue requirement for the Distribution Network Service Provider for that regulatory year.

Powercor proposed that, the word ‘materially’ to apply in respect of alternative control services for the purposes of the definitions of ‘positive change event’ and ‘negative change event’ in Chapter 10 of the Rules, the pass through events specified in clauses 6.6.1(a1)(1) to (4) of the Rules and nominated pass through events be modified to the ordinary and natural meaning of the term ‘materially’.<sup>11</sup>

We do not approve Powercor’s proposal for an alternative materiality threshold for pass through applications relating to alternative control services. The AEMC has commented, and we agree, that:<sup>12</sup>

Positive cost pass throughs exist in the rules as a mechanism to allow NSPs to recover their efficient costs incurred as a result of events that could not be forecast as part of their regulatory or revenue proposal that otherwise would have a *significant financial effect on the ability of networks to invest in and operate their networks*. [Emphasis added.]

Powercor’s proposal would also create uncertainty about when a pass through event is taken to have occurred. In response to a previous proposal that ‘material’ not be defined—that is, that it take its ordinary meaning—the AEMC commented:<sup>13</sup>

... that such an approach would introduce an undesirable degree of subjectivity into cost pass through determinations, and give the DNSPs too much of an avenue to submit applications, which may or may not be trivial in nature. On balance, the Commission considered that a materiality threshold needed to be specified to provide for greater certainty to both the regulator and the DNSP.

The current definition of ‘material’ provided by the NER provides clarity and certainty in the operation of the pass through mechanism. This supports the nominated pass through event considerations, which require that pass through events themselves be clearly identified at the time our determination is made. It also provides predictability and removes room for debate which, in the limited timeframes available for assessment of pass through applications, supports a more efficient and transparent process.

Powercor also proposed a variation to the control mechanism for alternative control services, so that approved pass through amounts would be recoverable from customers of alternative control services. As we do not approve a new materiality definition for alternative control services, we consider the rationale for Powercor’s

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<sup>11</sup> Powercor, *2016-2020 Price Reset, Appendix L Managing Uncertainty*, April 2015, p. 36.

<sup>12</sup> AEMC, *Rule determination—National Electricity Amendment (Cost pass through arrangements for Network Service Providers) Rule 2012*, August 2012, p. 2.

<sup>13</sup> AEMC, *National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012*, November 2012, p. 187.

proposed variation to the control mechanism at least in part falls away. It is unlikely a potential pass through event would meet the materiality definition in the NER if it impacted only Powercor's costs of providing alternative control services. Powercor may recover the full amount of an approved pass through via standard control service charges. We consider customers are no worse off under our approach because most, if not all, alternative control service customers are also standard control service customers.

We also consider Powercor's proposed control mechanism variation would make pricing alternative control services overly complex. We determine charges separately for individual alternative control services under a price cap control mechanism compared to the revenue cap for standard control services. The additional complexity associated with Powercor's proposed control mechanism variation is not justified by prospective advantages for Powercor, customers or other stakeholders.

### 15.4.2 Insurance cap event

The insurance cap event<sup>14</sup> would allow Powercor to recover material costs incurred which exceed its insurance claim policy limit. We accept an insurance cap event can be consistent with the nominated pass through considerations, if appropriately defined. In particular, we accept the insurance cap event would protect Powercor from high cost impact events which would be uneconomical to insure against. We consider consumers benefit because they are not required to fund excessive premiums where insurance, if available, would be uneconomic. Consumers then only bear the risk should an insurance cap event occur.

However, for the reasons below, we do not accept the insurance event proposed by Powercor and have substituted an alternative 'insurance cap event'. Powercor's proposed definition of this event relies on the definition in the current (2011–15) distribution determination for AusNet Services. In more recent decisions (in April 2015), we have given further consideration to the potential incentives under an insurance event of this nature. Our preliminary decision approves a narrower 'insurance cap event' to address these incentives, so that this event reflects the new nominated pass through considerations.<sup>15</sup>

The nominated pass through considerations require us to consider whether a prudent service provider could reasonably prevent an event from occurring or substantially mitigate the cost impact of such an event. We must also consider whether the relevant service provider could insure against the event, having regard to the availability (including the extent of availability in terms of liability limits) of insurance against the event on reasonable commercial terms.

Insurance is funded through Powercor's approved opex, which allows Powercor to acquire and maintain an appropriate level of insurance coverage. In allowing a pass

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<sup>14</sup> Powercor, *2016-2020 Price Reset, Appendix L Managing Uncertainty*, April 2015, pp. 12–14.

<sup>15</sup> NER glossary, definition of 'nominated pass through event considerations'.



through of costs in excess of Powercor's actual level of insurance, care must be taken to ensure it does not have a perverse incentive to reduce expenditure on insurance (and therefore its opex relative to the approved forecast), by transferring the risk of insurable events to customers. We expect Powercor to acquire prudent and efficient levels of insurance coverage commensurate with its business risk, as reflected in its approved forecast opex. Our substitute definition means that an insurance cap event will only occur when the costs Powercor incurs are the greater of: the level of insurance Powercor has actually purchased; and the policy limit that is assumed or provided for in determining its approved forecast operating expenditure (opex) under the access arrangement.

The NER list a number of relevant factors to which we must have regard in making a determination on a pass through application, including any factors the AER considers relevant.<sup>16</sup> We consider including additional factors we consider relevant to a nominated pass through event provides greater certainty and transparency in the operation of nominated pass through events. We consider this supports the nominated pass through event considerations, which require that events themselves can be clearly identified at the time of our determination.

We note if a pass through event of this type were to occur, in assessing Powercor's application to pass through costs we will consider the efficiency of Powercor's decisions and actions. We would consider whether it failed to take reasonable action to reduce the magnitude of the amount being claimed and whether any act or omission it took in response to the event increased the magnitude of the amount claimed.<sup>17</sup> This gives Powercor an incentive to mitigate the risks associated with the event including through acquiring an appropriate level of insurance and implementing other practical risk minimisation strategies in its operations. Our preferred definition explicitly clarifies that both Powercor's actual insurance policy and the level of insurance that an efficient and prudent service provider would obtain are relevant to this assessment.

Lastly, and for the reasons set out in section 15.4.1, our approved definition makes clear that this event will only be triggered where the costs incurred beyond the policy limit result in a material increase in the cost of providing direct control services.

Our preliminary decision is to approve the following definition of the insurance cap event:

An insurance cap event occurs if:

1. Powercor makes a claim or claims and receives the benefit of a payment or payments under a relevant insurance policy,
2. Powercor incurs costs beyond the relevant policy limit, and
3. the costs beyond the relevant policy limit materially increase the costs to Powercor in providing direct control services.

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<sup>16</sup> NER, cl. 6.6.1(j)(8).

<sup>17</sup> NER, cl. 6.6.1(j)(3).



For this insurance cap event:

4. the relevant policy limit is the greater of:
  - a. Powercor's actual policy limit at the time of the event that gives, or would have given rise to a claim, and
  - b. the policy limit that is explicitly or implicitly commensurate with the allowance for insurance premiums that is included in the forecast operating expenditure allowance approved in the AER's final decision for the regulatory control period in which the insurance policy is issued.
5. A relevant insurance policy is an insurance policy held during the 2016–20 regulatory control period or a previous regulatory control period in which Powercor was regulated.

Note for the avoidance of doubt, in assessing an insurance cap event cost pass through application under rule 6.6.1(j), the AER will have regard to:

- i. the relevant insurance policy for the event, and
- ii. the level of insurance that an efficient and prudent NSP would obtain in respect of the event.

### 15.4.3 Insurer credit risk event

This event would allow Powercor to pass through costs if an insurer becomes insolvent and Powercor is subject to higher or lower premiums, or a higher or lower claims limit or deductible. We accept an insurer credit risk event can be consistent with the nominated pass through considerations, if appropriately defined. We do not accept Powercor's proposed definition of this event.

Powercor's proposed insurer credit risk event<sup>18</sup> is broader in two respects than that we have approved in recent decisions.

First, in its proposed definition for this event, Powercor sought to include provision for it to pass through costs associated with changes to insurance premiums as a result of an insurer becoming insolvent.<sup>19</sup> The nominated pass through event considerations require us to consider whether a prudent service provider could reasonably prevent an event from occurring or substantially mitigate the cost impact of such an event.<sup>20</sup> We must also consider whether the relevant service provider could insure against the event, having regard to the availability (including the extent of availability in terms of liability limits) of insurance against the event on reasonable commercial terms.<sup>21</sup>

We consider insurance premiums are a typical business expense, subject to ordinary market factors in the economy. This is a risk businesses are best placed to manage, rather than customers. This view is consistent with our approach in recent decisions.

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<sup>18</sup> Powercor, *2016-2020 Price Reset, Appendix L Managing Uncertainty*, April 2015, pp. 10–12.

<sup>19</sup> Powercor, *Regulatory Proposal 2016-2020*, April 2015, p. 268.

<sup>20</sup> NER glossary, definition of 'nominated pass through event considerations', (c).

<sup>21</sup> NER glossary, definition of 'nominated pass through event considerations', (d).

Our substitute definition therefore does not allow Powercor to pass through higher or lower costs for insurance premiums as a result of the failure of an insurer.

Second, in recent decisions we have approved an insurer credit risk event that goes to costs specific to existing or potential claims to the failed insurer. Powercor's proposed definition does not include that limitation. When regard is had to the nominated pass through event considerations<sup>22</sup>, we consider this important so that service providers do not have the incentive to delay the purchase of alternative insurance, thereby transferring the risk of insurable events to customers.<sup>23</sup>

The NER list a number of relevant factors to which we must have regard in making a determination on a pass through application, including any factors the AER considers relevant.<sup>24</sup> As discussed above, we consider including additional factors we consider relevant to a nominated pass through event provides greater transparency in the operation of nominated pass through events and supports the nominated pass through event considerations.<sup>25</sup> Our substitute definition explicitly clarifies that Powercor's attempts to mitigate or prevent the event from occurring<sup>26</sup>, and whether it had a reasonable opportunity to obtain alternative insurance<sup>27</sup>, are relevant to this assessment.

We therefore do not accept Powercor's proposed definition of this event. Our preliminary decision is to instead approve a narrower and more clearly defined event, as follows:

An insurer's credit risk event occurs if:

A nominated insurer of Powercor becomes insolvent, and as a result, in respect of an existing or potential insurance claim for a risk that was insured by the insolvent insurer, Powercor:

- is subject to a higher or lower claim limit or a higher or lower deductible than would have otherwise applied under the insolvent insurer's policy; or
- incurs additional costs associated with funding an insurance claim, which would otherwise have been covered by the insolvent insurer.

Note: In assessing an insurer's credit risk event pass through application, the AER will have regard to, amongst other things,

- Powercor's attempts to mitigate and prevent the event from occurring by reviewing and considering the insurer's track record, size, credit rating and reputation.

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<sup>22</sup> NER glossary, definition of 'nominated pass through event considerations', (c), (d).

<sup>23</sup> NER glossary, definition of 'nominated pass through event considerations', (c).

<sup>24</sup> NER, cl. 6.6.1(j)(8).

<sup>25</sup> NER glossary, definition of 'nominated pass through event considerations', (b).

<sup>26</sup> NER glossary, definition of 'nominated pass through event considerations', (c).

<sup>27</sup> NER glossary, definition of 'nominated pass through event considerations', (d).

- In the event that a claim would have been made after the insurance provider became insolvent, whether Powercor had reasonable opportunity to insure the risk with a different provider.

#### 15.4.4 Natural disaster event

This event would allow Powercor to pass through costs associated with natural disasters.<sup>28</sup> We accept a natural disaster event can be consistent with the nominated pass through considerations, if appropriately defined. We note Powercor already has a range of measures in place to manage the risks posed by natural disasters, including a Crisis and Emergency Management System and bushfire mitigation strategies.<sup>29</sup> We do not accept the proposed definition because it does not sufficiently reflect the extent to which a provider could mitigate the cost impact of the event<sup>30</sup> and whether the provider could insure against the event.<sup>31</sup> To this end, we have substituted an alternative definition of this event.

We do not accept Powercor's proposed addition of 'major storm' to the definition of the natural disaster event.<sup>32</sup> We consider that a storm of sufficient magnitude to constitute a natural disaster is already captured by the words 'or other natural disaster'. Whether a relevant government authority has made a declaration in respect of a natural disaster event is a factor we would consider when assessing whether to accept such a pass through event. Our approved definition of this event explicitly recognises this, and more clearly identifies the nature and type of event that will be captured by this nominated pass through event.<sup>33</sup>

Further, we do not consider the characterisation of a *natural* disaster as 'beyond the reasonable control of the DNSP'<sup>34</sup> is appropriate. In the context of the pass through mechanism, the event is more appropriately identified by reference to the impact it may have on the DNSP. To that end, we consider the pass through event should be more clearly identified as requiring a natural disaster that was not a consequence of the acts or omissions of the service provider, but which has materially increased the costs to Powercor in providing direct control services.

The NER list a number of relevant factors to which we must have regard in making a determination on a pass through application, including any factors the AER considers relevant.<sup>35</sup> We consider including additional factors we consider relevant to a nominated pass through event provides greater transparency and certainty in the operation of nominated pass through events. We consider this clarity supports the nominated pass through event considerations above. We have therefore amended

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<sup>28</sup> Powercor, *2016-2020 Price Reset, Appendix L Managing Uncertainty*, April 2015, pp. 14–16.

<sup>29</sup> Powercor, *Regulatory Proposal 2016-2020*, April 2015, p. 268.

<sup>30</sup> NER, glossary, definition of 'nominated pass through event considerations', paragraph (c).

<sup>31</sup> NER, glossary, definition of 'nominated pass through event considerations', paragraph (d).

<sup>32</sup> Powercor, *2016-2020 Price Reset, Appendix L Managing Uncertainty*, April 2015, pp. 14–15.

<sup>33</sup> NER glossary, definition of 'nominated pass through event considerations', (b).

<sup>34</sup> Powercor, *2016-2020 Price Reset, Appendix L Managing Uncertainty*, April 2015, p. 14.

<sup>35</sup> NER, cl. 6.6.1(j)(8).

Powercor's proposed definition to reflect factors that we will have regard to when assessing a pass through application.

Whether a relevant government authority has made a declaration in respect of a natural disaster event is another factor we will consider when assessing whether a pass through event has occurred. This is therefore reflected in our definition. We will also consider what insurance Powercor has, what insurance an efficient and prudent distributor would have, against the impact of a natural disaster event. This is also reflected in our definition. We consider there may otherwise be some overlap between an insurance cap event and a natural disaster event, but accept the need to have both because Powercor may incur costs which an insurance policy would not ordinarily cover.

Our preliminary decision is to approve a narrower and more clearly defined natural disaster event, as follows:

A natural disaster event occurs if:

Any major fire, flood, earthquake or other natural disaster occurs during the 2016–20 regulatory control period and materially increases the costs to Powercor in providing direct control services, provided the fire, flood or other event was not a consequence of the acts or omissions of the service provider.

The term 'major' in the above paragraph means an event that is serious and significant. It does not mean material as that term is defined in the Rules (that is 1 per cent of the DNSP's annual revenue requirement for that regulatory year).

Note: In assessing a natural disaster event pass through application, the AER will have regard to, amongst other things:

- i. whether Powercor has insurance against the event,
- ii. the level of insurance that an efficient and prudent NSP would obtain in respect of the event,
- iii. whether a relevant government authority has made a declaration that a natural disaster has occurred.

### 15.4.5 Terrorism event

This event would allow Powercor to pass through the costs of terrorism events.<sup>36</sup> We accept a terrorism event can be consistent with the nominated pass through considerations, if appropriately defined.

Powercor's proposed definition of this event differs from that we have approved in recent decisions in two respects.<sup>37</sup>

First, Powercor's proposed definition expands on the examples provided of what might constitute an act of terrorism. It is intended to clarify that attacks against, and the

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<sup>36</sup> Powercor, *2016-2020 Price Reset, Appendix L Managing Uncertainty*, April 2015, pp. 16–19.

<sup>37</sup> See, for example: AER, *Final decision Ausgrid distribution determination, Attachment 15, Pass through events*, April 2015, p. 15-8.

deliberate introduction of harmful code of viruses to, computer systems and networks and communication systems can also be acts of terrorism.<sup>38</sup>

We consider the risk of such attacks can and should be managed primarily through prudent and efficient steps to protect its IT systems. We consider that if there is too much reliance on ex-post measures, Powercor would have disincentives to take prudent actions to manage the risk.<sup>39</sup> Powercor is provided an allowance for IT expenditure that should be used, in part, for securing its assets from such an event. The potential to recover costs by way of a pass through rather than within its approved expenditure forecasts should not form the basis of any risk management decision by Powercor.

This does not preclude an application by Powercor under the terrorism event where the event in question could properly be characterised as cyber-terrorism. In this respect, whether a relevant government authority has made a relevant declaration in respect of a terrorism event is one factor we would have regard to in considering whether to approve such a pass through event. In recent decisions we have explicitly noted this in defining a terrorism pass through event, to more clearly identify the nature and type of event contemplated. We consider this an appropriate constraint here, also.

Second, terrorism events approved by us in recent decisions explicitly require that the event increase the cost to the service provider of providing direct control services. Powercor argued that this was not necessary.<sup>40</sup> We consider that, as it is the change to the cost of providing direct control services that the pass through mechanism seeks to address, this specification is necessary to clearly identify the nature of this event.

Lastly, we consider it important the event definition recognise the extent to which a prudent service provider could reasonably prevent an event of that nature or type from occurring or substantially mitigate the cost impact of such an event, including whether the relevant service provider could insure against the event.<sup>41</sup> We propose amendments to the definition of this event which support the nominated pass through event considerations by incorporating factors we will have regard to when assessing a pass through application. These are the same factors as those discussed above in the context of the natural disaster event.

Whether a relevant government authority has made a declaration in respect of a terrorism event is a factor we will consider when assessing whether to a pass through event has occurred. This is therefore reflected in our definition. We will also consider what insurance Powercor has, and what insurance an efficient and prudent distributor would have, against the impact of a terrorism event. This is also reflected in our definition. We consider there may otherwise be some overlap between an insurance

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<sup>38</sup> Powercor, *2016-2020 Price Reset, Appendix L Managing Uncertainty*, April 2015, p. 17.

<sup>39</sup> NER glossary, definition of 'nominated pass through event considerations', (c).

<sup>40</sup> Powercor, *2016-2020 Price Reset, Appendix L Managing Uncertainty*, April 2015, p. 17.

<sup>41</sup> NER glossary, definition of 'nominated pass through event considerations', (c).

cap event and a terrorism event, but accept the need to have both because Powercor may incur costs which an insurance policy would not ordinarily cover.

These inclusions make clear we will take such factors into account in assessing whether a pass through event has occurred.

For the reasons above, we do not accept Powercor's proposed definition of this event. Our preliminary decision is to instead approve a narrower and more clearly defined terrorism event, as follows:

A terrorism event occurs if:

An act (including, but not limited to, the use of force or violence or the threat of force or violence) of any person or group of persons (whether acting alone or on behalf of or in connection with any organisation or government), which from its nature or context is done for, or in connection with, political, religious, ideological, ethnic or similar purposes or reasons (including the intention to influence or intimidate any government and/or put the public, or any section of the public, in fear) and which materially increases the costs to Powercor in providing direct control services.

Note: In assessing a terrorism event pass through application, the AER will have regard to, amongst other things:

- i. whether Powercor has insurance against the event,
- ii the level of insurance that an efficient and prudent NSP would obtain in respect of the event, and
- iii. whether a declaration has been made by a relevant government authority that a terrorism event has occurred.

#### 15.4.6 Retailer failure event

A retailer failure event would allow Powercor to pass through the costs for the provision of direct control services in the event of a retailer insolvency.<sup>42</sup> Since the National Energy Customer Framework (NECF) has not been adopted in Victoria, the prescribed retailer insolvency event under the NER does not apply to Victorian distributors. We consider it appropriate to provide equivalent protection through a nominated pass through event.

Powercor has proposed its own definition of this event, and in doing so has drawn on a rule change proposal currently under consideration by the AEMC.<sup>43</sup> The outcomes of that process are, as yet, unknown. The assumptions made in Powercor's proposal therefore create the risk that a nominated pass through event approved in the terms it has proposed would be inconsistent with that applied in other jurisdictions.

To ensure that the protection afforded Victorian distributors remains consistent with that available to distributors in NECF jurisdictions, we therefore consider it best to apply the NER event 'as in force from time to time'. In this way, changes to the NER

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<sup>42</sup> Powercor, *2016-2020 Price Reset, Appendix L Managing Uncertainty*, April 2015, pp. 28–32.

<sup>43</sup> Powercor, *2016-2020 Price Reset, Appendix L Managing Uncertainty*, April 2015, p. 29.

prescribed retailer insolvency event during the regulatory control period will also apply to Victorian distributors as they take effect.

We therefore approve the following, nominated pass through event for Powercor:

Prior to the commencement of the National Energy Customer Framework in Victoria, **retailer insolvency event** has the meaning set out in the NER as in force from time to time.

Note: This retailer insolvency event will cease to apply as a nominated pass through event on commencement of the National Energy Customer Framework in Victoria.

### 15.4.7 End of metering derogation event

An end of metering derogation event would allow Powercor to pass through costs associated with the end of the Victorian derogation from the metering provisions (under chapter 7 of the NER) and the introduction of metering contestability.<sup>44</sup> We do not accept this event because it would likely be covered under the regulatory change event or a service standard event, depending on the final form the framework takes.<sup>45</sup>

Powercor argues that the prescribed events may not apply as it is possible it will incur at least some of the costs prior to the expiration of the derogation.<sup>46</sup> We do not consider the prescribed regulatory change and service standard events necessarily preclude recovery of costs incurred under a change in obligations that has been made (for example, in a final rule change determination), if the date from which Powercor must comply with the changed obligation has been clearly specified.

### 15.4.8 Multiple trading relationships event

The multiple trading relationships event<sup>47</sup> relates to the proposed introduction of multiple trading relationships at a single connection point. This event would allow Powercor to recover the cost of changes potentially required to its information systems in response to NER amendments driven by the AEMC's Power of Choice review. As the NER amendments are not yet finalised Powercor is uncertain about the nature and scale of any such costs.

We consider this event would likely fall within the prescribed regulatory change and/or service standard events.<sup>48</sup>

Powercor has argued that it is unclear whether the prescribed regulatory change or service standard events would apply. This is because any such changes to Powercor's costs may result from changes to retail market procedures established by AEMO rather

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<sup>44</sup> Powercor, *2016-2020 Price Reset, Appendix L Managing Uncertainty*, April 2015, pp. 19–24.

<sup>45</sup> NER glossary, definition of 'nominated pass through event considerations', (a).

<sup>46</sup> Powercor, *2016-2020 Price Reset, Appendix L Managing Uncertainty*, April 2015, p. 23.

<sup>47</sup> Powercor, *2016-2020 Price Reset, Appendix L Managing Uncertainty*, April 2015, pp. 24–28.

<sup>48</sup> NER glossary, definition of 'nominated pass through event considerations', (a).

than under a rule change, administrative act or decision.<sup>49</sup> However, we consider the retail market procedures take effect as obligations under the NER. Therefore, changes to the retail market procedures would also take effect under the NER and would be covered by either the regulatory change or service standard events.<sup>50</sup>

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<sup>49</sup> Powercor, *2016-2020 Price Reset, Appendix L Managing Uncertainty*, April 2015, p. 27.

<sup>50</sup> NER glossary, definition of 'nominated pass through event considerations', (a).